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No. 722

In the Supreme Court of the United States

OCTOBER TERM, 1957

VICTOR H. AND ELSIE AKIN, FRED C. AND ALICE M. KLUVER, E. F. AND GLADYS MUNROE, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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OPINIONS BELOW

The findings of fact, conclusions of law and opinion of the District Court (Pet. A–1–10) are not reported. The opinion of the Court of Appeals (Pet. A–11–14) is reported at 248 F. 2d 742.

JURISDICTION

The judgment of the Court of Appeals was entered on October 19, 1957. (Pet. A–14; Supp. R. 10.)[1]

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[1] References designated "R." are to the transcript of record filed in the Court of Appeals. References designated "Supp. R." are to the supplementary typewritten transcript of record filed in this Court.

The petition for a writ of certiorari was filed on January 14, 1958. The jurisdiction of this court is invoked under 28 U. S. C., Section 1254 (1).

QUESTION PRESENTED

Whether portions of annual assessments paid by taxpayers in 1949 and 1950 to two mutual ditch companies and used by such companies to retire long-term indebtedness and for the purchase of a right of way were, as taxpayers claim, deductible from their gross income as ordinary and necessary business expenses, or whether, as held by the Commissioner, they were non-deductible capital contributions.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [as amended by Sec. 121, Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) In General.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of prop-

erty to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(26 U. S. C. 1952 ed., Sec. 23.)

SEC. 24. ITEMS NOT DEDUCTIBLE.

(a) *General Rule.*—In computing net income no deduction shall in any case be allowed in respect of—

* * * * *

(2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate;

* * * * *

(26 U. S. C. 1952 ed., Sec. 24.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.22 (a)-16. *Contributions to Corporation by Shareholders.*—

If a corporation requires additional funds for conducting its business and obtains such needed money through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special capital account, such amounts will not be considered income, although there is no increase in the outstanding shares of stock of the corporation. The payments under such circumstances are in the nature of voluntary assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company. * * *

STATEMENT

The facts, as stipulated by the parties (R. 11–20) and as found by the District Court (R. 21–23), may be summarized as follows:

Taxpayers are engaged in the business of farming in Colorado, and obtain their water for irrigation purposes through two mutual ditch companies of which they are stockholders. These companies, the Water Supply and Storage Company and the North Poudre Irrigation Company, were incorporated in Colorado in 1891 and 1901, respectively, for the purpose of acquiring and maintaining land, water rights and appropriations, acquiring or constructing and maintaining reservoirs, ditches and necessary structures, and distributing water to stockholders owning land under their ditches in Larimer and Weld Counties. Both companies had the right under their charters to borrow money, to secure loans, and to procure funds on the company property or franchises. In order for a water-right owner to be entitled to receive water distributed by the companies, he was required to have stock in the company with all assessments paid. If a stockholder became in default, interest was charged from the date due until payment. If he remained in default 30 days after notice and demand for payment of an assessment, his stock could be sold at public auction. (R. 12, Stip. Exs. P–1 and Q–2.)

In 1949 and 1950, the Water Supply and Storage Company had 286 and 285 stockholders respectively, and its capital stock consisted of $60,000 or 600 shares of $100 par value. Mr. Akin owned 2½ shares of

stock and the Kluvers 14 shares. (Stip. Ex. R–3.)

In 1949 and 1950, the North Poudre Irrigation Company had 332 and 331 stockholders respectively, and its capital stock consisted of $500,000 or 10,000 shares with a par value of $50. The Akins owned 365 shares, the Kluvers owned 417 shares in 1949 and 317 shares in 1950, and Mr. Munroe owned 107 shares. (Stip. Ex. S–4.)

During each of the taxable years 1949 and 1950, the companies levied annual assessments on their stockholders. Taxpayers paid their assessments and deducted the amounts paid as ordinary and necessary business expenses in their income tax returns. (R. 13.)

The Commissioner disallowed a portion of the deductions taken by taxpayers on the ground that such portions did not constitute ordinary and necessary expenses of carrying on their farming operations, but represented amounts allocated or spent by the two companies for items of a capital nature, as follows (R. 13–18):

In 1948, $3.05 of the $12 per share North Poudre assessment was allocated to the retirement of $30,500 of the principal of a long-term mortgage debt. One-half of the $3.05 was paid in 1949 and disallowed as a deduction in that year.

In 1949, $4.45 of the $11 per share North Poudre assessment was disallowed since $3.17 per share was allocated to the payment of $31,700 of the principal of a mortgage note, and $1.28 per share for the purchase at $12,800 of a right of way for the Colorado Big Thompson Ditch.

In 1950, $4.60 of the $12 per share North Poudre assessment was disallowed since $3.30 was allocated to the payment of $33,000 of the principal of a mortgage note, and $1.30 for the purchase at $13,000 of a right of way for the Colorado Big Thompson Ditch.

In 1949, $71.66-2/3 of the $220 per share Water Supply Company assessment and in 1950 $73.33-1/3 of the $220 assessment were disallowed since both amounts were applied toward the retirement of the principal of a long-term mortgage note to the extent of $43,000 and $44,000 respectively.

The following deficiencies in tax were attributable to the disallowance of the portion of the assessments referred to (R. 22, 23):

	Deficiency	Interest
1949		
Akins	$606.72	$96.13
Kluvers	1,135.90	164.25
Munroes	182.14	2.93
1950		
Akins	576.91	
Kluvers	1,135.90	154.56
Munroes	237.38	23.97
	3,874.95	441.84

The District Court held that taxpayers correctly deducted the disallowed amounts of the assessments and that they were entitled to the refunds claimed. (R. 24–25.) The Court of Appeals reversed, holding that the amounts disallowed by the Commissioner represented capital contributions to the two companies, rather than ordinary and necessary expenses incurred in carrying on the business of the taxpayers. (Pet. A–1–14.)

ARGUMENT

The decision of the court below is clearly correct. As taxpayers recognize, outlays which constitute capital contributions are not deductible as "ordinary and necessary expenses" in carrying on a trade or business under Section 23 (a) (1) (A) of the Internal Revenue Code of 1939. See 1939 Code Section 24 (a) (2); *Welch* v. *Helvering,* 290 U. S. 111, 115. In drawing the line between a business expense and a capital expenditure, the nature of the obligation out of which the payment arose must be considered. Moreover, the claimed deduction must be examined in the light of the familiar rule that an income tax deduction is a matter of legislative grace, and that the burden of clearly showing the right thereto is on the taxpayer. *Interstate Transit Lines* v. *Commissioner,* 319 U. S. 590, rehearing denied, 320 U. S. 809. See also *Deputy* v. *du Pont,* 308 U. S. 488; *Welch* v. *Helvering, supra.*

In general, an expenditure should be treated as capital outlay if it is for the acquisition of an asset having a useful life in excess of one year. *Hotel Kingkade* v. *Commissioner,* 180 F. 2d 310 (C. A. 10th). Expenditures for a right of way and for the retirement of long-term indebtedness clearly fall within that category. Money spent or allocated for a right of way is a capital expenditure, for it is designed to expand the particular system and create additions to it. *Haller* v. *Commissioner,* 14 B. T. A. 488, petition for review dismissed November 21, 1932

(C. A. D. C.); see, also, *Cripple Creek Coal Co.* v. *Commissioner,* 63 F. 2d 829 (C. A. 7th); *Atlantic Coast Line Railroad Co.* v. *Commissioner,* 31 B. T. A. 730, affirmed, 81 F. 2d 309 (C. A. 4th), certiorari denied, 298 U. S. 656; *Caflisch Lumber Co.* v. *Commissioner,* 20 B. T. A. 1223. Likewise, an amount paid to retire the principal of long-term indebtedness is not a current business expense, but a capital expenditure. *King Amusement Co.* v. *Commissioner,* 44 F. 2d 709 (C. A. 6th), certiorari denied, 282 U. S. 900; *Newark Milk & Cream Co.* v. *Commissioner,* 34 F. 2d 854 (C. A. 3d). As the court below held (Pet. A–13–14), the effect of the payments used in the retirement of the long-term indebtedness of the mutual irrigation companies was to strengthen their financial position by reducing their long-term obligations. This is fully supported by the record which shows that the bonded indebtedness of the companies is or soon will be non-existent, and that the shareholders will thus receive the tangible benefit of reduced assessments as a result of their prior contributions to capital. (See audit reports, Stip. Exs. AA–12, BB–13, Government Exs. 1, 2.)

The disallowed portions of the assessments, i. e., the portions applied by the mutual irrigation companies to the retirement of the principal of long-term indebtedness and for the purchase of a right of way, were stipulated to have been "expenditures of a capital nature" (R. 14–15), and the District Court so found (R. 22, par. 9). In view of this stipulation and finding of fact, the Court of Appeals most certainly did not

violate the "clearly erroneous" rule (Rule 52 (a)) when it reversed the District Court for failing to hold as a matter of law that taxpayers were not entitled to deduct these amounts as current business expenses.

Taxpayers emphasize the peculiarities of water problems in Colorado, contending that, since they are obligated to pay the assessments before they can receive any water, the entire amount of the assessment is an ordinary and necessary expense of conducting farming operations. (Pet. 10–12.) This Court's decision in *Farmers Irrigation Co.* v. *McComb*, 337 U. S. 755, refutes the notion that an assessment by a mutual irrigation company is an annual payment for water as such. The stockholders of a mutual irrigation company have an undivided right in the physical assets of the company, and assessments (as do the disallowed portions here involved) may result in a strengthening of the stockholders' financial position in such assets. The fact that taxpayers under Colorado law (2 Colorado Revised Statutes (1953), Section 31–14–4) and by agreement (Stip. Exs. P–1, Q–2) may not receive delivery of any water until all assessments shall have been paid obviously does not mean that the entire amount of the annual assessments represents the annual price of the water, or current business expenses. The contention that the payments should be deductible because they are *necessary* in order to obtain water overlooks the fact that the element of necessity alone does not determine the deductibility of an expenditure. The fact that a taxpayer may be compelled by necessity to make capital improvements and expenditures does not mean that these are deductible business

expenses. *Mt. Morris Drive-In Th. Co.* v. *Commissioner,* 238 F. 2d 85 (C. A. 6th), affirming 25 T. C. 272; *Cripple Creek Coal Co.* v. *Commissioner,* 63 F. 2d 829 (C. A. 7th). Moreover, the "mere fact that the expense was incurred under contractual obligation does not of course make it the equivalent of a rightful deduction under Section 23 (a)." *Interstate Transit Lines* v. *Commissioner,* 319 U. S. 590, 594.

Contrary, therefore, to taxpayers' contention (Pet. 10–11), the disallowed portions of the assessments—those relating to the retirement of long-term debt and the purchase of a right of way—were not the ordinary costs of operation and maintenance. The portions of the assessments which were used to defray ordinary expenses of operation and maintenance, such as those incurred for ditch cleaning, weed cutting, and the like, were allowed as deductions.

There is no showing in the record to support taxpayers' contention (Pet. 7, 14) that a denial of the claimed deductions would result in unjust or oppressive consequences. In accordance with Treasury Regulations 111, Section 29.22 (a)–16, *supra;* p. 3, the proper way to treat the disallowed portions of the assessments is to add such amounts as an additional cost of taxpayers' stock in the mutual irrigation companies. In any event, the allowance of deductions does not turn upon equitable principles. *Interstate Transit Lines* v. *Commissioner, supra; Deputy* v. *du Pont, supra; White* v. *United States,* 305 U. S. 281; *New Colonial Co.* v. *Helvering,* 292 U. S. 435.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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